VZCZCXRO1319
PP RUEHLMC
DE RUEHLP #2447/01 3191556
ZNY CCCCC ZZH
P 141556Z NOV 08
FM AMEMBASSY LA PAZ
TO RUEHC/SECSTATE WASHDC PRIORITY 9249
INFO RUEHAC/AMEMBASSY ASUNCION 8552
RUEHBO/AMEMBASSY BOGOTA 5911
RUEHBR/AMEMBASSY BRASILIA 9875
RUEHBU/AMEMBASSY BUENOS AIRES 7095
RUEHCV/AMEMBASSY CARACAS 4143
RUEHGE/AMEMBASSY GEORGETOWN 0897
RUEHPE/AMEMBASSY LIMA 4471
RUEHMD/AMEMBASSY MADRID 4311
RUEHMN/AMEMBASSY MONTEVIDEO 5955
RUEHQT/AMEMBASSY QUITO 6760
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RUEHUB/USINT HAVANA 1519
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C O N F I D E N T I A L SECTION 01 OF 04 LA PAZ 002447

SIPDIS

E.O. 12958: DECL: 11/12/2018
TAGS: ECON PGOV PREL ENRG EPET EINV BL
SUBJECT: BOLIVIA: MAS ECONOMIC RECIPE FOR A DIFFICULT YEAR
AHEAD

REF: A. LA PAZ 2341
¶B. LA PAZ 2392
¶C. LA PAZ 2388

Classified By: Acting EcoPol Chief Brian Quigley for reasons 1.4 b, d.

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Summary
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¶1. (C) Prominent La Paz economic authorities generally agree that the current international economic crisis will not severely impact Bolivia until April or May of next year. While Movement Toward Socialism (MAS) policy during yet another "election year" in Bolivia will cushion many Bolivians against commodity price drops, fiscal and monetary policy decisions may set the stage for considerable pressure on the domestic currency by the summer. Moreover, as the government intervenes even more deeply in the economy and the likely new MAS Constitution once again shifts the ground rules for investment, narcotraficking and resulting strength in construction may be the only growth areas in the Bolivian economy for 2009. End Summary.

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State of the Bolivian Economy
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¶2. (C) The Chief Economist at the Central Bank Raul Mendoza estimates that the Bolivian economy will close 2008 with 6.7 percent annual growth rate and an inflation rate of around 12 percent. For 2009, Mendoza estimates these figures will be around 5 percent GDP growth with 9 to 10 percent inflation (Note: Production from the U.S. owned San Cristobal mine which came on line in 2008 accounted for over 2 percent of GDP growth in 2008. End note). While the numbers are respectable, Mendoza did say there would be a gradual decline in the current accounts, pointing to a drop in remittances (estimated to fall by around 15 percent in 2009), declining export prices, and increased imports driven by public sector investments.

¶3. (C) According to Napoleon Pacheco, Director of the Bolivian economic think tank the Millennium Foundation, the government will really begin to feel the effects of the international economic crisis by spring of next year. Fernando Rodriguez, Director General of the government's Public Financial Unit also identified that time period as critical for the economy. He pointed to the delay with which drops in commodity prices are felt by the central government. For example, there is a ninety day clearance period for payment of gas exports. On top of that, prices are only periodically adjusted, so current market prices will not translate into lower prices for several months. Finally, tax revenue on hydrocarbon and mineral exports is collected only once a year. As a result, Rodriguez said that only recently did the central government collect what was owed on exports for 2007 (this is not true however for royalties which are paid as the resource is extracted). In other words, declines in commodity prices will take a time to impact the government's bottom line, but with a budget calculated on US$73 a barrel oil, government coffers will eventually be emptier than previously assumed.

¶4. (C) Regardless, the central government is planning on a significant ramp-up in public investment. The official website proudly proclaims that 2009 will set a record for public investment of US$1.9 billion, whereas when Morales entered the presidency in 2006 this figure was programmed for only US$762 million. Additionally, social spending commitments also continue to rise. Not only has the Morales'



administration implemented several inclusive entitlement programs (Renta Dignidad, a federal retirement program, and Juancito Pinto, an incentive program for children to attend school), it has also announced a 14 percent rise in the salaries of public health and education workers, as well as a 12 percent rise in formal salaries across the board. Moreover, to help placate miners adversely affected by declining prices, the government has set an artificial floor on the price of zinc (Ref. A) and is considering similar subsidies for other minerals. The bottom line is that after several years of surplus, Bolivia is looking at a fiscal deficit for 2009. The manner with which the government confronts this new reality will be critical.

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Government Strategies and the International Reserves
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¶5. (C) It is becoming increasingly clear that President Morales intends to follow through on his frequently voiced desire to spend some of the over US$7 billion dollars in international reserves held at the Central Bank. Currently, all public institutions, including the executive, are legally forbidden from obtaining loans from the Central Bank reserves. (Note: There is an exception for natural disasters. The executive took advantage of this exception during the 2008 floods to request US$600 million in loans. To date only US$250 million have been accessed and even less than that effectively dispersed. No official request for access to the additional US$350 has yet been made. End note). The new MAS Constitution appears to eliminate these restrictions. The recent revisions to the document strike the language from Article 327 explicitly giving the Central Bank "administrative and technical autonomy" (Ref. B), but also eliminate language in Article 328 that forbids the Central Bank from giving loans or guarantees to individuals or public institutions.

¶6. (C) An additional check on Morales' access to reserves was removed with the replacement of the Central Bank President with a the former MAS Minister of Development Gabriel Loza. Shortly following his appointment, Loza was already saying that interest on the reserves could be used to carry out MAS government programs. He did make a point of

asserting the Central Bank's independence from the Ministry of Treasury (it is widely assumed that Minister of Treasury Arce was instrumental is getting Loza appointed as Central Bank President). However, International Monetary Fund representative in La Paz Esteban Vesperoni theorized to Econoff that this declaration only indicated that Loza intends to work more closely with the Executive rather than the Treasury. In any case, it appears that the Cental Bank is headed towards a less autonomous, more political future. (Note: Central Bank employees now are required to attend indoctrination sessions on Friday afternoons where Cuban and Marxist propaganda movies and documentaries are shown. End note.)

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Monetary Policy Advancing MAS Priorities
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¶7. (C) Despite a recent reduction in the annual inflation rate, there is little doubt that a top economic priority of the Morales' administration is control over prices. On the day of his appointment, Loza announced that he would seek to fix the U.S. dollar exchange rate. Declaring a stable exchange rate in the face of sharp declines in the currencies of neighboring countries bucks the regional trend. While exporters in Brazil, Chile, and Argentina seek to capitalize on improved terms of trade, Bolivian exporters will continue to struggle with a strong national currency (the boliviano).



However, imports will continue to be "cheap" and, in line with MAS priorities, the fight against inflation will take precedence over giving a boost to productive sector exports.

¶8. (C) Private investors are beginning to take note. Through August no significant sales of the domestic currency were made in the foreign exchange markets. However, in September and October around $350 million dollars were purchased, about half of which is estimated to have left the country (Ref. C). Public Financial Unit Director Rodriguez was sanguine about this emerging capital flight, saying that it actually helps sterilize domestic liquidity, which has been the driving force behind inflation. Clearly, a complete loss in confidence in the boliviano would be devastating, but for the moment Rodriguez was not concerned. Marcelo Montero, Director of the Banking Association (ASOBAN) also did not see capital flight as a problem in the short term. A majority of domestic debt and savings is now in the national currency, so while a more fixed exchange rate may signal a new dolarization of the Bolivian economy, Montero said that for the moment Bolivians have more confidence in their currency than ever before and that they believe their savings are safe in the domestic banks.

¶9. (C) Montero went on to explain that member banks have little exposure to the bad assets plaguing larger international banks and that the sector will enjoy record profits in 2008. Most of these profits were made by taking advantage of a large spread given by the Central Bank, i.e. they could buy bolivianos cheaply and resell them at a higher rate. Ominously, the biggest problem facing large Bolivian banks is what to do with their liquidity. Montero says that currently no loans are being placed. There are simply no areas in the domestic economy where the banks are willing to make loans and/or where the private sector is soliciting them. This is nothing new for 2009 either, there has been a lack of private sector investments in the productive sector in Bolivia for the past several years. Eventually, production levels in mining, hydrocarbons, electricity, and manufacturing will suffer, but for now investments made before 2005 are carrying the economy.

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Informal Economy as a Cushion and Social Demands
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¶10. (C) The informal economy has traditionally cushioned Bolivians against economic crisis. This pattern is likely to continue in 2009 as drug trafficking expands following the expulsion of DEA and more coca-friendly policies by the Morales administration. Just as Morales himself left the altiplano to grow coca during the mining crisis in the 1980s, many out of work cooperative miners could follow his example in the coming months as falling mineral prices force the closure of less efficient cooperative mines. Unemployment in the mines and resulting social unrest is a much clearer threat to Morales than worries about becoming a narco-state.

¶11. (C) In addition to the expanding narco-economy, Bolivia will need to deal with demands from social sectors who feel increasingly entitled and empowered to benefit from any economic activity, especially those related to natural resources. The Director General of the Corani Electrical Company Jose LaFuente recently told Econoff that he was leaving his position in part because the demands made by workers and neighboring communities were becoming unbearable. (Note: Corani's parent company Econergy, headquartered in Colorado, was recently sold to a French gas company. This sale ends any U.S. participation in the electricity sector in Bolivia and also contributed to LaFuente's resignation. End Note.)



¶12. (C) Public demands on business will also likely be given a boost with the MAS Constitution. Article 313 states that, "in order to eliminate poverty and social and economic exclusion . . . Bolivian economic organization establishes" such things as "the reduction of inequitable access to productive resources and the just production, distribution and redistribution of wealth and economic profits." Moreover, it gives the Indigenous Autonomies the specific right to "control and monitor the social/environmental impacts of hydrocarbon and mining activities which are developed in their jurisdiction." There is no telling just how many workers are socially justifiable for a gas well in the Chaco region or an hydroelectical plant in Cochabamba.

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Comment
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¶13. (C) While Bolivia looks set to weather the economic crisis in the short-term, long-term threats to its economy abound. Perhaps principal among them is an erotion of faith in the currency. A stong currency is viable only as long as investors and savers believe in the economy (i.e. the production of goods and services) that stands behind it. While high commodity prices boosted the bottom line for Bolivia, there have been no significant gains in production across any of the major areas of the economy (hydrocarbons, mining, and agriculture). Large public investments over 2009 are unlikely to change this reality. The state hydrocarbon company (YPFB) may drill a number of new wells, spending hundreds of millions of dollars, but if all they have to show for it are dry holes, there will be no lasting production growth. Moreover, pouring money into state paper, milk, or even mining opperations are also unlikely to contribute to long-term growth. If the government additionally spends international reserves on such ventures, while also artificially proping up the currency, a sharp decline in the exchange rate could easily be accompanied by significant capital flight. At some point, faith (and growth) in Bolivia will need to be backed up by gains in production; gains which are currently nowhere in sight.

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